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MX
SUBJECT: THE GOM'S 2010 REVENUE PROPOSAL

REF: A. MEXICO 2639
¶B. MEXICO 2537
¶C. MEXICO 2709

¶1. (SBU) Summary. Fiscal reform has become a critical element in addressing the GOM's 2010 budget shortfall, resulting from plunging revenues (due to falling oil production/prices and economic recession), and public expenditure that grew in tandem with skyrocketing oil prices from 2002-08 (see reftels). On September 8, the GOM submitted to Congress the 2010 economic bill, which contains proposals to amend the tax laws. The most important tax proposals are:

- Increasing the corporate and maximum individual income tax rate from 28 to 30%, and imposing limits on companies filing consolidated returns;
- Eliminating the flat tax &loss credit8 against income tax due in the same fiscal year;
- Increasing the tax on cash deposits and lower the exemption cap;
- Introducing a new contribution similar to the VAT to combat poverty that would tax all activities at 2%; and
- Significantly increasing the excise tax on specific goods and services.

The GOM's economic package has been criticized for largely focusing on attaining short-term fiscal stability for the purpose of preventing a downgrade from the rating agencies (see reftel C). It achieves this stability through regressive taxes and other measures that hurt the country's competitiveness. End Summary.

Overview of Mexico's Revenue Structure

2.(U) Mexico's revenue structure can be divided into 3 broad categories: tax, nontax, and public enterprise revenues. The later consists basically of revenues from Pemex, the oil company; CFE, the electricity company; and IMSS, the Social Security Institute. Nontax revenue is mostly related to oil exports on which the government collects a hefty percentage through a &royalty8 that is not considered a tax.

¶3. (U) Tax revenue on its own represents approximately 10% of GDP, which ranks Mexico among the lowest in the world. This consists of income tax, 48% of the total; value added tax (VAT), 38%; and special taxes on products and services (IEPS), 6%; and all other taxes, 8%. (Note: Because of

loopholes, deductions, and exemptions associated with the income tax (ISR), the GOM in 2008 introduced the corporate flax tax (IETU) of 17% minimum. In 2008, the traditional ISR collected 4.6% (including individuals) of GDP and the IETU registered an additional 0.4%. End Note.) Although the VAT is 15%, the structure is full of exemptions and exceptions such as food and medicine. As a result, the entire VAT recollection accounts for only 3.8% of GDP, which points to a very inefficient tax administration.

Tax Reforms

¶4. (U) On September 8, the GOM presented its proposed revenue package to Congress with significant tax law changes. The tax reform includes permanent and temporary tax proposals to increase both consumption and production taxes. These proposals are subject to Congressional approval and changes are likely prior to final approval. Primary taxes still remain in effect, including income tax (ISR), flat tax (IETU), the VAT, excise taxes and others. A summary and commentary of the more significant proposed changes follow in paragraphs 5)15.

Consumption Taxes

¶5. (U) Anti-Poverty Tax (Anti-Poverty Contribution - CCP): A new 2% sales tax similar to the VAT would be enacted to help reduce poverty, and would have few exemptions, such as export

sales. This tax would be creditable by businesses. While value-added tax (VAT) remains unchanged at 15%, the proposed sales tax would mean a 17% de facto rate, and cover all goods and services, including many currently exempt from VAT (particularly foodstuffs, medicines, and health services).

¶6. (SBU) Mexican economist Rogelio Ramirez de la O told econoff that this tax was introduced as a &sales tax8 because PRI party statues forbid the approval of a &VAT8 on food and medicine. Separately, Price Waterhouse Cooper (PWC) analysts) which, according to Econ sources, participated in the pre-budget negotiations among the GOM, PAN, and PRI) said the idea behind the CCP is to gradually (over the next few years) replace the VAT, which has many exemptions. Some critics note that the tax will affect economic drivers such as tourist services and call centers. Comment: The GOM is essentially trying to enact a parallel tax, as it did at the end of 2007 with a flat-rate business tax, known as IETU, which is a parallel income tax without existing exemptions and loopholes. End Comment.

¶7. (U) To justify the name of the tax as a contribution against poverty, 36% is earmarked for an anti-poverty program called &Oportunidades.8 This would represent an estimated 50% increase (from MX$47 to MX$74bn) in subsidies to poor households through Oportunidades. There would also be an additional 20% increase in the program Seguro Popular (national health insurance), which provides limited medical coverage with subsidized premiums. Seguro Popular is administered by each of the states; federal resources are transferred to the states through the National Health System, the Mexican Social Security Institute (IMSS), or through Oportunidades. (Comment: States receive over 90% of their funds from the federal government. State finances are generally perceived as lacking in adequate oversight/accountability measures. End comment.)

8.(U) Excise taxes (Special Tax on Production and Services - IEPS): The GOM is proposing an additional tax increase on beer, alcohol, tobacco, telecommunications charges, and gambling/lottery activities. While the demand on these products in considered by some to be relatively &inelastic,8 PWC analysts note that if the tax increases

beyond the equilibrium, more revenue will not necessarily be generated and it could cause market distortions (i.e. black markets, contraband).

9.(U) The GOM is also proposing a 4% tax on telecommunications (except in rural areas). Telecoms, considered to be one of the most important sectors for increasing the country's competitiveness, will be hit hard with the 4% IEPS plus the 2% CCP. The average telephone, internet, and paid television user would pay a total of MX$138 (approximately US$10) of tax per month for those services; a sum equivalent to almost 3 days minimum wage salary. Currently the average telcom user spends MX$758 (or US$58) per month. The proposal would reduce new infrastructure investment, drag on growth in mobile and internet penetration, and disproportionately fall on low income users.

Income Taxes

10.(U) Regular Income Tax Rates (ISR): The highest marginal regular income tax rate (for corporations and individuals) would temporarily increase from 28% to 30% for three years (2010, 2011 and 2012), and would be reduced to 29% in the fourth year (2013), finally scaling back to 28% in 2014. For the primary sector (i.e. agriculture, cattle, etc.), the maximum rate would increase from 19% to 22.5%. While many other countries are reactivating their economies by cutting corporate taxes in order to spur investment and employment, the GOM is taking the opposite approach by proposing a production tax increase. However, unlike other economies with stronger fiscal systems, Mexico's tax revenues are very low (10% of GDP) and there is a heavy dependence on oil revenues (see reftels).

11.(SBU) Minimum Flate-Rate Tax (IETU): This tax was part of the fiscal reform passed in 2007. Because of loopholes, deductions, and exemptions associated with the ISR, the GOM introduced a minimum flat tax on businesses of 17%. Currently, if a taxpayer generates a tax loss credit for IETU purposes, the credit may be applied against the income tax of the year. Though a rule included in the Federal Revenue Law, deductions and credits would not be allowed in the same year. This provision would only apply for 2010 unless enacted again in future years. There is also a concern for U.S. companies operating in Mexico that the U.S. will no longer recognize and credit the IETU, so U.S. companies will end-up having to pay double taxes.

¶12. (U) Tax Consolidation Regime (TCR): Significant changes would be made to the TCR. Although qualifying taxpayers would continue to be allowed to offset losses against profits of other entities within a consolidated group and to distribute dividends tax-free between group members, the following changes are proposed:

-- 60% of any deferred income tax would have to be paid in the fifth year following the year in which such losses were offset or dividends paid, with the balance of 40% to be paid in equal amounts over the subsequent 4-year period. This provision would be applicable for all prior fiscal years under tax consolidation (current rules allow deferral until certain deconsolidation events take place). Thus, if this amendment is passed, 60% of separate company unamortized tax losses generated in 2004 and in prior years would be triggered in 2010. These new recapture rules would also apply to deferred taxes on intercompany dividends within the consolidated group and other similar consolidation benefits.
-- A group would be deemed deconsolidated if the deferred tax was not paid.
-- An independent auditor would be required to review and certify the calculation and payment of the deferred tax.

13.(U) Under this proposal, the GOM expects to collect MX$27.6bn, which is 16% of the total amount that the GOM expects to collect from all taxes or the whole reform. While the business sector is unhappy with the increase in the corporate income tax, they are especially concerned about the reform in the consolidation regime. They complain that the changes do not give legal certainty to investors and are an excessive fiscal burden particularly for exporters.

Financial Services

¶14. (U) Tax on Cash Deposits (IDE): The tax on cash deposits would be increased from the current rate of 2% to 3%, and the monthly limit on the aggregate tax-free cash deposits would be reduced from a current floor of MX$25,000 to MX$15,000. Fortunately, the IDE would still be creditable against other taxes. Last year, IDE collected MX$17bn.

Other Noteworthy Measures

15.(U) Other significant and/or controversial revenue-generating measures include:

-- Terminating the freezing of energy prices, which will be reflected in a steady monthly increase. In gasoline, the price would jump by 17.1% in 2010. It is worth noting that a similar increase was responsible for the pick up in inflation in 2008. Comment: Most analysts would revise their 2010 inflation projections upward (near 5%) under this fiscal reform plan. End Comment.

-- Giving the Tax Administration System (SAT) the authority to freeze taxpayers, bank accounts whenever money is due to the Finance Secretariat and also allowing them to collect what is due from those accounts.

Analysts, Impressions

16.(SBU) Dr. Jose Luis de la Cruz, an economist at Monterrey Tech (ITESM) told econoffs that the tax proposals aim to recover the fall of budget revenue but there is no clear long-term policy that will increase growth and competitiveness. He also noted that the budget maintains the same current expenditures while lowering investment. Similarly, other analysts we spoke to say the GOM's fiscal reform will have a short-term collection effect, but lacks a long-term strategy to make everyone pay taxes. (Note: The total number of taxpayers is 9 million; the total number of companies paying taxes is 600,000, whereas the informal sector reaches 12 million in a population of 105 million inhabitants. End Note.)

¶17. (SBU) Moreover, the projected cuts in spending and increases in tax revenue satisfy the immediate cash needs of the GOM, but only at the cost of accentuating the recession by weakening consumer demand. PWC analysts note that the income tax increase for individuals will have a higher impact on the medium and upper classes since their net income will be reduced by -2.11% for those earning MX$60,000 a month, -1.49% for those earning MX$25,000, and -1.07% for those making MX$13,000. Discouraging consumption in effect hurts sales of companies and employment. Unemployment in Mexico is already at 6.25% -- its highest level in 13 years) and the 2008 poverty rate is 47.4%, up from 42.6% in 2006. While some of the negative effects will be offset through Oportunidades grants to low-income households, other households (i.e. the middle class) will suffer a negative impact additional to the loss in disposable income from job losses, reductions in nominal wages, and price increases.

(Note: Mexico's official definition of unemployment leads to an underestimate of the jobless, because it excludes some persons who could be counted as unemployed under the U.S. concept. Moreover, it masks a large number of persons in unstable marginal jobs. End Note.)

¶18. (U) The Mexican Competitiveness Institute (IMCO) also criticized the tax reform for raising the cost of production, which will have a negative impact on competitiveness. IMCO recommends instead a general consumption tax and making transfers to vulnerable groups so that they are not affected by the tax (as it is regressive).

Opposition Response

¶19. (SBU) Although some observers believe the economic package was pre-negotiated between the GOM and the leadership of the PRI, many perceive the rank and file of the PRI as reluctant to pass significant tax increases or subsidy reductions. At the same time, the PRI wants to be seen as a responsible opposition and they know something has to be done to improve the country's public finances so they do not inherit the same problems if/when they come to power in 2012. The 2% sales tax is clearly the toughest political battle. While the PRI and the PRD have made alot of noise opposing a new tax, the PRI might vote in favor of it if food and medicines are excluded. On September 23, PRI Senate leader Manlio Fabio Beltrones said the discussion lies not on the income part (new/increased taxes) but how the new revenue will be spent to create more jobs. Hence, much of the noise against the new taxes may just be &theatrics8 so that Calderon and the PAN absorb the political cost of the reform.

¶20. (U) The PRI has also circulated alternative/supplemental proposals. The most noteworthy include:

-- Eliminating some of the tax exemptions included in the current VAT, such as education, transportation, books, etc. (without touching food and medicine).

-- Instead of increasing the income tax (ISR) and approving the 2% CCP, the PRI has proposed a revision/elimination of the 200 existing loopholes in the ISR. Comment: This would be politically difficult given the various interest and

business groups that benefit from these special regimes. End Comment.

-- Amending the Federal Royalty Law: A PRI lawmaker from Guanajuato introduced an initiative to levy mining extractions and exploitation with a 4% tax on metallic and non-metallic products. The revenue collected will go to the states: 20% to the &Fondo General de Participaciones8; 80% to a fund for the states where the mines are located. Analysts at Price Waterhouse think both the PRI and the GOM will approve this measure, despite the precarious situation of the mining sector.

Comment

21.(SBU) The GOM's economic package has been criticized for largely focusing on attaining short-term fiscal stability for the purpose of preventing a downgrade from the rating agencies (see reftel C). It achieves this stability through regressive taxes rather than taking on larger structural deficiencies like trying to eliminate special regimes (loopholes, subsidies) which currently represent an estimated 3.9 percentage points of GDP in forgone revenue. This, however, would be a larger political battle than proposing new/increased taxes given all the vested interests that currently benefit from these special tax regimes. The

reforms also reduce Mexico's competitiveness by increasing the cost of production. In short, the GOM has opted to balance the budgets on the backs of SMEs and the middle-class, rather than confront monopolies and major businesses.

¶22. (SBU) At the same time, given Mexico's history and bad experience with large foreign debt, deficits, and economic crisis, the GOM is taking the orthodox approach of preserving macroeconomic stability. Unlike other developed economies, Mexico still has significant contingent liabilities that make it difficult to increase the public deficit and debt. Currently, total accumulated public borrowing requirements total 40% of GDP. (Note: De la Cruz told econoffs that if we take into consideration past pension regimes before the reforms of the Mexican Social Security Institute (IMSS, 2005) and Security and Social Services for Government Employees (ISSSTE, 2007), as well as the states and other government parastatals, the broad debt would amount to 100% of GDP. End Note.)

¶23. At the same time, if the GOM fails to get its tax proposal through Congress and expenditures remain constant, the GOM will face a fiscal gap for 2010 and may have to resort to incurring more debt. There is no clear indication that the GOM has an alternative to its tax proposal. Meanwhile Secretary of Finance Agustin Carstens is pressing states to pursue their own funds through property tax collection; a clear strategy remains to be seen on this front as well.

24.(U) This cable focuses on the revenue side of the GOM's 2010 Economic Plan. A separate report will follow on the expenditure component.
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